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Memo

ANDERSEN

To Files
From David D. Duncan
Debra A. Cash
Date October 15, 2001
Subject Enron-Raptor Entity Note Impairment

Overall Background
The Raptor entities are a series of SPE's (LLP's in form) set up for the purpose of hedging certain merchant investments where Enron perceived it had significant exposure to volatility. In early September, 2001, Enron brought to our attention that it believed there might be significant impairment of certain notes it had with the Raptor entities. In addition, Enron informed us that they were considering approaching the Raptor counterparties to negotiate to settle out of the entities because of changes in their top management and their desire to extract themselves from various structured activity which has been perceived negatively by the analyst community. (On September 27, 2001, Enron terminated their arrangements with these entities.) As a result of this impending and potentially significant reporting event, combined with the complexity and sensitivity of the related party disclosures associated with the Raptor transactions, we undertook to review our collective accounting advice related to these vehicles with the Professional Standards Group (PSG) and others in practice and risk management.

Reference is made to memos dated December 31, 1999, as amended October 12, 2001, March 28, 2000, as amended October 12, 2001 (Raptor Transaction), July 28, 2000, July 31, 2000 (Raptor II Transaction), November 9, 2000 (Raptor III Transaction), as amended, October 12, 2001, and December 27, 2000 (Raptor IV Transactions). December 28, 2000, as amended, October 12, 2001, May 9, 2001, as amended. October 12, 2001, July 17, 2001, August 31, 2001 and September 1, 2001 for background on the "Raptor Entities".

In connection with our review, the PSG advised us that the use of the aggregated impairment test methodology that had been adopted by the client, was not an acceptable impairment test methodology. This advice was consistent with the PSG's views expressed in December 2000, and at that time the client adopted an approach with which the audit team concurred based on issues deemed to be audit considerations. (See Memo dated December 28, 2000, as amended October 12, 2001.) .

Enron's Impairment Methodology

On September 26, 2001, Enron had approximately $2.4 billion of net notes receivable from the Raptor entities. The notes are consideration received by Enron for 1) prior sales of Enron restricted stock and stock rights and 2) the settlement of net amounts due from the Raptor entities related to various derivative instruments. The notes bear interest at 7% with interest and principal due in April 2005, when the Raptor entities are scheduled to automatically liquidate.

Enron also had approximately $500 million, $690 million and $640 million of price risk management assets related to derivatives with the Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001, respectively. The instruments meet the definition of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" and were reported on Enron's books at fair value. These price risk management assets will be the subject of a separate memorandum.

In addition to the notes and derivatives, at the time of the formation of each of the Raptor vehicles, Enron purchased, for nominal consideration, a non-voting member interest in each vehicle which gave Enron the rights to any residual value available, upon liquidation of the vehicles, after achievement of a certain stated return for the outside equity investors.

Beginning in late 2000, and continuing more precipitously in 2001, many of the financial instruments in the Raptor entities declined in value. We had numerous discussions with management regarding how the Company determines when an impairment of the Raptor related derivatives and notes receivable had occurred.

The Company determined that the notes do not represent a share, participation or interest in the underlying assets of the entities. Although the only transactions that the Raptor entities have are with Enron, and Enron can only look to the underlying assets within Raptor for credit purposes, the form of the notes are not debt securities as defined under SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." Accordingly, with no other specific literature on point, Enron management determined that SFAS No. 114 was the appropriate authoritative guidance for determining impairment with respect to the notes and we concurred. SFAS No. 114 states, "a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The term "probable" as used in SFAS No. 114, is consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of loss." Probable is the area within that range where such future events are likely (vs. reasonably possible) to occur. Although the notes should be displayed as an offset to equity (see September 1, 2001 memo), these notes are unlike normal subscription receivables because failure to pay would not result in return of Enron stock. Therefore, the Company concluded that any impairment on the notes should be charged to income.

SFAS No. 114 goes on to state that "measuring impaired loans requires judgement and estimates... creditors should have latitude to develop measurement methods that are practical in their circumstances". "A creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that, as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable".

Considering the guidance in SFAS 114, Enron proposed an approach to evaluate the collectibility of the Raptor notes using Monte Carlo and other simulation methods that would reflect Enron's view that declines in value could recover over the holding period of the notes. Enron noted that many of the financial instruments underlying the notes had exhibited, and would be expected to continue to exhibit, a high degree of volatility. Since the notes were not scheduled to be repaid for a number of years, Enron's position was that SFAS 114 gave Enron the flexibility to estimate what it thought was a likely outcome considering this time horizon.

As we considered Enron's proposed approach through the second quarter, we noted that SFAS 114 does give a creditor a choice of measurement alternatives, as described above, and does not dictate one approach over another (unless the notes are collateral dependent and it is determined that foreclosure is probable, which it was not in this situation). SFAS 114 allows for subjectivity with regard to expected future outcomes and we could not disagree that simulation methods were appropriate methods for determining the likelihood of possible future value outcomes. We noted also that Enron uses the Monte Carlo simulation method in other aspects of its business and has substantial experience in applying this method. We informed Enron that our preference, as an indicator of potential impairment, would be a more objective evaluation approach using the loans' underlying collateral value with that collateral value limited to the publicly traded price of the underlying securities, where available.

An issue we considered was whether utilizing the screen price (publicly quoted price) for the restricted Enron stock related instruments was appropriate (as opposed to a discounted value that might be appropriate if the current restrictions on these instruments were considered). We noted that foreclosure with respect to the notes was not indicated and that there was nothing to indicate, through the second quarter, that the notes would be settled prior to their scheduled liquidation. We noted that the restrictions naturally expire at or before the scheduled liquidation and that the ultimate collateral would be unrestricted shares. We determined that it was appropriate to consider this contractual event that will occur, that is the expiration of the restrictions, in assessing the probability of collection on the notes given those facts and circumstances. We informed Enron that, if those facts and circumstances changed, whereby 1) foreclosure became imminent or 2) there was an intention to settle the Enron stock related instruments prior to the lapse of the restriction and their scheduled liquidation, the impairment test should then only consider the current settlement value of the restricted securities (which we would expect would be an amount less than screen).

Considering our views, Enron proposed to limit its views of recovery to the value of the underlying collateral securities in the vehicle using current publicly trade prices, but to perform their impairment assessment on an aggregate (of all of its interests in all of the vehicles) basis, rather than on an entity-by-entity basis, beginning in the first quarter of 2001. In connection with the development of this alternative, Enron negotiated an agreement in March 2001 with the Raptor entities that 1) assigned Enron's rights to receive any distributions from these instruments in any of the respective Raptor entities to other Raptor entities, to the extent such entities have obligations due to Enron that cannot be fully paid by the Raptor entity, 2) restricted Enron's ability to sell any portion of its rights to interests in any Raptor entity prior to the liquidation date and 3) realigned the various liquidation dates of the Raptor entities, previously in different months and years, to all occur simultaneously (April 2005). The effect of the assignment was that Enron committed to forego its rights to its member interest in Raptor entities where such interest may have value for the benefit of other Raptor entities that could not fulfill their obligations to Enron at liquidation.

Enron's position was that, while the March 2001 agreement was not required, it would help address our concerns of subjectivity (by lending some discipline and objectivity to the overall assessment) and noted that it would never yield a result more favorable than the net amounts recoverable from the entities if all positions (that is, Enron's notes receivable from the Raptor entities, price risk management asset related to the Raptor entities, and Enron's member interests in the Raptor entities) were liquidated as scheduled (as indicated by current prices). Also, although Enron had always viewed these exposures in the aggregate from a practical standpoint, they believed that the change they implemented with the March 2001 agreement gave important legal form (in terms of the order of liquidation) to that position and lent support to their approach.

As we considered the acceptability of Enron's conclusion, we made the following observations:

- SFAS 114 1) does not dictate a methodology for estimating future cash flows for purposes of determining impairment unless foreclosure is probable, 2) recognizes that expected cash flows are "usually uncertain" and that a "creditor will be required to exercise significant judgement in developing the estimates of future cash flows", and 3) states that "creditors should have latitude to develop measurement methods that are practical in the circumstances". The net result of this was our view that SFAS 114 allows for judgment and the use of different approaches.

- In other areas of authoritative literature where impairment is based on fair value, we noted that the overriding concept was for declines that are "other than temporary". The AICPA Audit and Accounting Guide related to Auditing Derivative Instruments, Hedging Activities, and Investments in Securities states in part in paragraph 47..."Regardless of the valuation method used, generally accepted accounting principles might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors that may indicate an impairment.

    - Fair value is significantly below cost and -
        - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
        - The decline has existed for an extended period of time.
        - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value."

    (Remainder of paragraph not included)

  We noted that, although SFAS 114 does not require a fair value approach (unless foreclosure is probable) and is therefore possibly more subjective than this concept, that considering this concept in our facts and circumstances might help us determine reasonable limits to the subjectivity we might accept. We noted that the recent declines in the value of the various underlying financial instruments which might indicate impairment had been rapid and precipitous and many of these financial instruments had demonstrated a great deal of volatility. We further noted that Enron had the ability to hold the notes for a period over which they might recover.

- The Raptor entities and related exposures are very unique and complex. As structured transactions they are very form driven. The client's view was that the form of the assignment they used in their "aggregation" methodology was important. We were concerned that the assignment was not substantive since it did not appear to, other than the realignment of the settlement dates, impact anyone but Enron. We acknowledged, however, that Enron had indeed contracted with the Raptor entities to legally change the form of ultimate settlement. In addition, Enron's methodology institutionalized an impairment test using current market values without reliance on more subjective matters of judgment as to future performance and volatility of the underlying assets of the Raptor vehicles.

Considering all of the above factors, and that 1) any indicated impairment resulted from what management believed to be temporary declines of volatile instruments and 2) the net result of Enron's methodology was to impair the notes and price risk management assets in the aggregate to the extent that currently indicated recoverable values of all positions demonstrated a net economic loss during first quarter 2001, we determined Enron's methodology was reasonable. We believed that the issue was an audit issue and given the latitude allowed under SFAS 114 necessitated that we discuss our conclusions with the Practice Director and Concurring Partner. In late March 2001, we discussed our conclusions with Mike Odom, Practice Director, and Mike Lowther, Concurring Partner, who concurred.

Third Quarter Review

In the third quarter, the Company informed us it would be recognizing a significant impairment. In connection with our review of the Company's accounting for impairment, we consulted with the PSG, which expressed concerns with respect to the client's use of the aggregated impairment test methodology notwithstanding our other considerations. In the PSG's view, the cross assignment should not be given accounting recognition because it is an agreement between related parties that had no economic consequence to Enron or to any other entity, and the apparent purpose was to achieve a financial reporting objective.

While we had believed that the approach adopted by the client was practical in the circumstances for all of the reasons previously mentioned, we 1) informed Enron management that we now viewed their use of the aggregated impairment test methodology to be incorrect, 2) asked Enron to adopt an acceptable methodology and 3) began a more detailed review of the vehicles on an entity-by-entity basis to determine whether we believed an impairment would be required in any prior periods considering alternative methods.

Enron continued to believe their methodology to be reasonable. However, they also did not believe that any additional impairment would be warranted at the end of the first or second quarter if they assessed impairment on a disaggregated basis using screen prices and, where appropriate, Monte Carlo simulation methodologies. .They again pointed out that SFAS 114 does not prescribe that a term loan is required to be marked to the current market value of the underlying collateral unless foreclosure is probable. As has been previously discussed, our reading of SFAS 114 supported this view. Enron also pointed out:

1. The investments in the Raptor vehicles have a history of high volatility and,
2. For the most part, the underlying investments in the under-water vehicles were in operating entities with prospects for recovery. Enron believed that acceptable simulation models applied to all of the underlying investments of the Raptor entities would indicate that no impairment was required at the end of any of the previous reporting periods.

Attachment I is a summary of the results of an entity-by-entity review of the Raptor vehicles based on the analysis prepared by Enron. After reviewing Enron's analysis, we determined that Raptor I, II, III and IV required further analysis. Enron assessed the derivatives separately from the notes. Enron recorded the derivatives at fair value, considering the credit worthiness of the counterparty. (Our analysis of this approach is subject to a separate memo). Enron assessed the notes as follows:

Step 1. Quarterly, determine on an entity by entity basis, whether there is an indication of a possible impairment. An indication of a possible impairment would be if the net fair value of all the financial instruments of an entity, using screen prices at the date of evaluation, is less than the recorded amount of the notes and price risk management assets on Enron's balance sheet with that same entity. If the fair value exceeds the note and price risk management assets balance on Enron's books, no further analysis for impairment is necessary for the period. If the total fair value of the assets is less than the notes on Enron's books with that entity, further analysis is warranted to determine if the notes have been impaired. Based on this step, Raptor II required no further analysis for note impairment.

Step 2 (step 2 is performed only if a possible impairment is indicated by step 1). Statement 114 states that a loan is considered impaired when it is <u>probable</u> that a creditor will be <u>unable</u> to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. The Company concluded that it is appropriate to use a 75 percent likelihood of occurrence as being "probable." We agree that 75 percent is a reasonable percentage to use as being "probable." Accordingly, if there is at least a 25 percent chance that the principal and all future interest due under the notes will be collected when due, then it is not probable the Company will be unable to collect all amounts due; thus the notes are not impaired.

The debtors own equity securities and are party to various derivative financial instruments for which the underlyings are equity securities. Using information about an equity security's current price and its historic volatility, the likelihood of any future price being achieved can be determined for most equity securities using a Monte Carlo simulation method. As we consulted with valuation experts in our Financial and Commodity Risk Consulting Group, we determined that, Monte Carlo simulation methods may not produce the most reasonable possible outcomes for some equity securities. For example, it would not be appropriate to use Monte Carlo for companies in bankruptcy or for companies not expected to have a future stock price. It theoretically would be acceptable to use Monte Carlo for companies in severe financial difficulty. However, the alternative method described here takes a more cautious approach. If the value of an equity security has declined since the debtor acquired the equity security (or entered into the related derivative) and the value has not recovered within a six month period, that company is presumed to be in severe financial difficulty and is specifically reviewed to determine if its specific facts and circumstances can overcome the presumption that Monte Carlo would not be used. Indicators that would overcome that presumption include improving operating results, positive cash flow, and successful execution of its business strategy.

Accordingly, the equity securities (both owned and used as underlyings in derivatives) should be separated into two groups -- those equity securities for which future prices can be modeled using a Monte Carlo simulation model and those for which Monte Carlo may not produce the most reasonable outcomes. For those equity securities for which Monte Carlo simulation is not applied, current fair value of the equity security is used as the estimate of the equity security's future value.

For equity securities whereby the Monte Carlo simulation model is applied, the Company used that model to determine the lowest equity security price in a range of most favorable potential outcomes that has a 25 percent likelihood of occurring at a future specific date. For owned equity securities, that future date is the date the debtor entity is scheduled to be liquidated and the notes paid. For equity securities that are an underlying for a derivative financial instrument, that future date is the date the derivative is scheduled to settle and that future equity security price is the price used to estimate the amount of the ultimate settlement of the derivative.

If the projected resources of the debtor, using the amounts computed as described in the preceding paragraphs, are sufficient for the debtor to pay all amounts when due (principal and interest), the notes are not impaired. If the projected resources of the debtor are not sufficient, the notes are impaired.

Step 3 (step 3 is performed if step 2 results in a conclusion that the notes are impaired) Once a note is identified as being impaired under SFAS 114, the emphasis changes and requires that the lender make its best estimate of what cash flows <u>will</u> be collected. The notes are written down to the amounts recoverable from the underlying financial instruments held by the specific Raptor entity. The current screen price represents the best estimate of what will be collected.

We discussed this "three step" approach with members of the PSG (John Stewart, Rick Petersen, Ben Neuhausen, and Amy Ripepi). They concurred with our conclusion that this approach to assessing and measuring impairment of the SFAS No. 114 notes is acceptable.

We reviewed the client's analysis using this alternative, assessed management's judgements, and tested their calculations. We also reviewed information concerning significant portions of the underlying collateral to test the Company's use of the methodology described above. Based on this work, we concurred with the Company's conclusion that no impairments would have needed to be recorded on the notes with Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001. See attachments I, A1, A2 and A3 that support our conclusions.

We discussed our conclusions with those listed below, who concurred.

Steve Goddard
Bill Swanson
Mike Odom
Mike Lowther

Rich Corgel
John Geron
Gary Goolsby
Larry Rieger